FINSEC Law Advisors

SECURITIES AND INVESTMENT REGULATIONS

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Brightline test for Control

SEBI has recently issued a discussion paper containing proposals to overhaul the definition of 'control' within the Takeover Regulations, 2011. Control is presently defined as the right to appoint majority of the directors or to control the management or policy decisions of a company. Determination of control is straightforward where these rights accrue simply based on shareholding in the company. However, as the definition also takes into account whether these rights are accruing through other arrangements, including by virtue of their management rights, shareholders agreements or voting agreements, 'control' has become a complex and contentious issue. Some are of the view that, by only providing broad contours of what would constitute control, there is vast scope for interpretation and a multitude of opinions. In this light, SEBI has proposed two possible options for revising the definition of control.

Adopting a numerical threshold: One of the options proposed by SEBI is to overhaul the definition of control entirely and base the new definition on a numerical threshold of 25%, irrespective of whether there is de facto control, and the ability to appoint a majority of the non-independent directors. The concern with this approach is that it may lead to instances where persons not in control are incorrectly adjudged to be in control while others who have control, through means other than shareholding, are left unaffected. This may undermine the intent behind the Takeover Regulations and the requirement of making an open offer on acquiring control. For the sake of simplicity of understanding and ease of working, changes to securities law cannot be made with shortcuts in reasoning.

Framework of Protective Rights: One of the concerns with the present definition is that protective rights being given to financial investors are often being interpreted as amounting to 'control'. In this light, without overhauling the definition, SEBI proposes to create a list of protective rights that would not amount to control and may be bestowed upon investors, who have invested atleast 10% in the target company, without triggering an open offer obligation. This would include rights such as the right to appoint a non-executive chairman without a casting vote, certain veto/ affirmative rights in regard to decisions which are not part of ordinary course of business, etc. This option may be explored further, keeping in mind the need to avoid rigidities, as contentious issues faced by investors seeking protective rights are addressed by it. As any list of protective rights that do not amount to control cannot be exhaustive, SEBI may also consider instituting an approval mechanism where other contentious protective rights can be decided upon on a case to case basis.

More Investment Options for FPIs

SEBI, through a circular dated March 15, 2016, has expanded the list of securities which Foreign Portfolio Investors (FPIs) can invest in. The SEBI (FPI) Regulations, 2014, state that FPIs can only invest in securities specified under Regulation 21(1) therein. Following RBI's decision to permit FPIs, through its circular dated November 16, 2015, to invest in Real Estate Investment Trusts (REITs), Infrastructure Investment Trusts (InvITs) and Alternative Investment Funds (AIFs), SEBI has notified units of REITs, InvITs and Category III AIFs as eligible securities under Regulation 21 of the SEBI (FPI) Regulations, 2014. However, investment in category III AIFs has been restricted to 25%.

Further, SEBI has also permitted FPIs to acquire NCDs/bonds, which are under default, either fully or partly, in the repayment of principal on maturity or principal instalment in the case of an amortising bond. FPIs shall be guided by RBI's definition of an amortising bond. The minimum maturity period for such restructured bonds would be three years. This is in furtherance of RBI's enabling notification dated November 26, 2015 which permitted FPIs to acquire NCDs/bonds, which are under default.

This is a welcome move as it widens the scope of foreign investment in vehicles which are designed to invest in two critical economic segments - real estate and infrastructure. In addition, creditors would now be able to restructure NCDs/bonds which are under default, with the help of foreign capital.

Order in the matter of Sharepro Services (I) Pvt. Ltd.

The Whole Time Member, SEBI, passed an ex-parte ad interim order dated March 22, 2016, against Sharepro Services, a SEBI-registered Registrar and Share Transfer Agent. Sharepro had allegedly transferred dividends belonging to rightful investors, to entities part of or related to the management of Sharepro. Law requires dividend proceeds to be paid only to genuine shareholders and if they are not traceable, the unclaimed dividend is to be transferred to the Investor Education and Protection Fund. However Sharepro allegedly misused its authority to instruct bankers directly, or misled companies to issue instructions to bankers, for crediting dividend payments to persons who were not rightful shareholders or were not at all shareholders of the companies.

Further, SEBI found that shares belonging to registered shareholders were illegally transferred to relatives of Sharepro's management. It repeatedly printed new share certificates without any request or authorisation of the shareholder and transferred shares belonging to, for instance, a deceased shareholder to persons connected with the management, without proper documentation. The share folio in Sharepro's system was transferred from the name of one shareholder to another person connected with the management of Sharepro, without any record of the transactions. On many occasions shares were transferred under the pretext of rectification of records, and not as transfer/transmission/buy-sell entry.

SEBI, amongst other findings, found that Sharepro had made circuitous transfers and falsified the records to blur any audit trail, engaged in forgery, failed to exercise care and due diligence, did not have control over share transfer operations and found that the senior management, in collusion with other entities, facilitated these violations.

Accordingly, Sharepro, its senior management and several entities linked with the management were restrained from dealing in the securities market in any manner for contraventions of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 2003, the SEBI (Registrar to an Issue and Share Transfer Agents) Regulations, 1993, and the SEBI Act, 1992. Furthermore, the client companies of Sharepro were directed to conduct an audit of the records of Sharepro pertaining to dividends paid and transfers effected for the past 10 years, and also advised such companies to switchover to another SEBI-registered RTA or undertake such functions in-house. These directions will have significant impact on several listed companies for which Sharepro is the RTA. Notably, the order does not provide any protection or relief as such to the affected investors, nor does it indicate whether the particular companies in question can be made liable for the acts of Sharepro, i.e, the RTA.

SEBI's Discretion in deciding Quantum of Penalty

Section 15A of the SEBI Act, 1992 empowers SEBI to impose penalties for failure to furnish information, make disclosures, etc. In relation to the interpretation of this section as it stood after its amendment in 2002 and before it was again amended in 2014, a division bench of the Supreme Court, in SEBI v. Roofit Industries Limited, had recently held that, an adjudicating officer was conferred no discretion while deciding the quantum of penalties to be imposed for violations that took place during the said period. As the consequence of this decision was the imposition of a penalty of Rs. 1 crore for any failure to make disclosure or any disclosure delayed by a 100 days or more, it is set to have far reaching implications on the securities market in India. However, another division bench of the Supreme Court, in its recent order passed in the matter of Siddharth Chaturvedi v. SEBI, stated that it does not subscribe to the rationale laid down in the Roofit case.

In the Siddharth Chaturvedi case, the question of the interplay between Section 15A and Section 15J of the SEBI Act, 1992, was considered. Section 15J provides various factors which the Adjudicating Officer of SEBI has to take into consideration while deciding the quantum of penalty. The Supreme Court stated that it is difficult to appreciate as to how the imposition of penalty under Section 15A, as amended in 2002, maybe construed in isolation without giving regard to factors to be considered under Section 15J. The court further added that if we were to subscribe to the interpretation suggested in the Roofit case, it would be very difficult for Section 15A to be construed as a reasonable provision, as it would then arbitrarily and disproportionately invade the appellants' fundamental rights and may lead to anomalous results.

In this light, it was decided that these matters deserve consideration at the hands of a larger bench and the case has been placed before the Hon'ble Chief Justice of India to this end. As both judgements are from division benches of the Supreme Court, the Siddharth Chaturvedi case does not overrule the views expressed in the Roofit case. Therefore, it is hoped the Supreme Court expedites the process and provides clarity on the discretion available to Adjudicating Officers.

Enhanced Disclosures for Mutual Funds

SEBI issued a circular dated March 18, 2016, substantially increasing the disclosure requirements for mutual funds. In regard to disclosures in the Consolidated Account Statement, the circular now requires the CAS to provide the total purchase value/cost of investment in each scheme and the half-year CAS to disclose the amount of actual commission, monetary and otherwise, paid by AMCs/MFs to distributors during the half-year period against the concerned investor's total investments in each MF scheme. Additional requirements have been imposed in relation to disclosures on the dashboard on their MF websites, within the scheme information document, key information memorandum, etc. This includes disclosures pertaining to the remuneration of MF Chief Executive Officers, ratio of CEO's remuneration to median employee remuneration, etc. Further, to ensure that MFs reduce reliance on credit rating agencies and lower the risk of defaults, the Circular mandates fund houses to have an appropriate system to conduct in-house credit risk assessment before investing in fixed income products.

While SEBI's move is aimed at increasing transparency in the operation of MF and helping align aspects such as executive remuneration with investors' interests, it entails considerable risks. Although investors will have access to a greater degree of information, can investors make of all this new information? There may be a possibility of the information being misconstrued and investors being dissuaded from investing in mutual funds. For instance, while spelling out distributors' commission in absolute terms may be directed at curbing mis-selling, it may lead to investors pulling out and going direct, if they are unhappy with high distributor commissions. Given that direct plans are meant for sophisticated investors who can choose and track MF schemes on their own, unqualified retail investors taking the direct investment route could be dangerous. Transparency cannot come at the cost of hampering the growth of the mutual fund sector.

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Finsec Law Advisors is a financial sector law firm which provides regulatory advice and assistance focusing on the securities, investments and banking industry.

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